

Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **202009024**

Release Date: 2/28/2020

CC:EEE:EOET:ET1:NPark
POSTN-130821-18

UILC: 1402.01-00, 465.00-00

date: March 04, 2019

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subject: Whether the Basis Loss Limitation and the At-Risk Loss Limitation Apply in
Determining a General Partner's Self-Employment Tax

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Whether the basis loss limitation under § 704(d) and the at-risk loss limitation under § 465 apply to determining a general partner's net earnings from self-employment (NESE) under § 1402 for Self-Employment Contributions Act (SECA) tax purposes.

CONCLUSION

Unless a specific exclusion applies under § 1402(a) to the facts of a case, the basis loss limitation under § 704(d) and the at-risk loss limitation under § 465 apply in determining a general partner's NESE under § 1402 for SECA tax purposes.

EXAMPLE

You have asked for advice on the following general fact pattern:

LLC ("LLC") elected to be treated as a partnership for federal tax purposes. The LLC has three (3) individual members: Member A, Member B, and Member C. All three

members are general partners of the LLC. The LLC is involved in the single activity of contracting for the production of widgets for customers.

During the tax year X, the LLC had a current year operating loss. Net operating loss carrybacks and carryovers are not at issue. All LLC members received guaranteed payments in the tax year. To determine the amount of NESE subject to SECA tax for the tax year: Member A reduced his guaranteed payment by his individual share of the partnership's losses without applying the basis loss limitation under § 704(d); Member B reduced his guaranteed payment by his individual share of the partnership's losses without applying the at-risk loss limitation under § 465; and Member C had sufficient basis and at-risk amounts to apply his share of the partnership loss against his guaranteed payment. In addition, Member C's share of partnership loss was not limited by the passive activity loss limitation under § 469 because Member C materially participated in the LLC.

All the members agree that the loss limitations apply in determining their income subject to federal income taxes. However, Member A and Member B argue that the basis loss limitation under § 704(d) and the at-risk loss limitation under § 465 do not apply in determining their NESE subject to SECA tax, respectively. Member C's share of the partnership loss was not limited by any of the loss limitations.

LAW AND ANALYSIS

Section 1401 of the Code imposes SECA tax for each taxable year on the self-employment income of every individual for such taxable year. SECA tax consists of Old-Age, Survivors, and Disability Insurance (OASDI) tax under section 1401(a) and Hospital Insurance (HI) tax under section 1401(b).

Section 1402(b) of the Code generally defines "self-employment income" as the net earnings from self-employment derived by an individual during any taxable year; except that such term shall not include –

(1) in the case of the OASDI tax imposed by section 1401(a), that part of the net earnings from self-employment which is in excess of (i) an amount equal to the contribution and benefit base (as determined under section 230 of the Social Security Act) which is effective for the calendar year in which such taxable year begins, minus (ii) the amount of the wages paid to such individual during such taxable year; or

(2) the net earnings from self-employment, if such net earnings for the taxable year are less than \$400.

Section 1402(a) of the Code defines the term "net earnings from self-employment" as the gross income derived by an individual from any trade or business carried on by such

individual, less the deductions allowed by subtitle A¹ which are attributable to such trade or business, plus the individual's distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member, with certain enumerated exceptions.

Section 1.1402(a)-2(d) of the Income Tax Regulations provides that the net earnings from self-employment of an individual include, in addition to the earnings from a trade or business carried on by him, his distributive share of the income or loss, described in section 702(a)(8), from any trade or business carried on by each partnership of which he is a member. An individual's distributive share of such income or loss of a partnership shall be determined as provided in section 704, subject to the special rules set forth in section 1402(a) and in §§ 1.1402(a)-1 to 1.1402(a)-17, inclusive, and to the exclusions provided in section 1402(c) and §§ 1.1402(c)-2 to 1.1402(c)-7, inclusive.

Section 1.1402(a)-3 of the Income Tax Regulations provides that for the purpose of computing net earnings from self-employment, the gross income derived by an individual from a trade or business carried on by him, the allowable deductions attributable to such trade or business, and the individual's distributive share of the income or loss, described in section 702(a)(8), from any trade or business carried on by a partnership of which he is a member shall be computed in accordance with the special rules set forth in §§ 1.1402(a)-4 to 1.1402(a)-17, inclusive.

Section 465(a) of the Code allows any loss from an activity for the taxable year only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of subsection (b)) for such activity at the close of the taxable year for individuals and C corporations that meet the stock ownership requirement under section 542(a)(2) [i.e., five or less individuals owning more than 50 percent in value] engaged in an activity to which this section applies.

Section 469 of the Code disallows passive activity losses and passive activity credits for the taxable year for individuals, estates, trusts, closely-held C Corporations, and personal service corporations.

Section 1.469-1T(d)(3) of the Income Tax Regulations provides that, except as otherwise provided in regulations, a deduction that is disallowed for a taxable year under section 469 and the regulations thereunder is not taken into account as a deduction that is allowed for the taxable year in computing the amount subject to any tax imposed by subtitle A of the Internal Revenue Code.

The following example in the regulations illustrates the application of § 1.469-1T(d)(3):

¹ Subtitle A of the Internal Revenue Code encapsulates §§ 1 through 1564. Section 1.1402(a)-1(a)(1) of the Income Tax Regulations more specifically references deductions allowed by chapter 1 of the Code, which includes §§ 1 through 1400Z-2.

Example. An individual has a \$5,000 passive activity loss for a taxable year, all of which is disallowed under § 1.469-1T(a)(1). All of the disallowed loss is allocated under § 1.469-1T(f) to activities that are trades or businesses (within the meaning of section 1402(c)). Such loss is not taken into account for the taxable year in computing the taxpayer's taxable income subject to tax under section 1. *In addition, such loss is not taken into account for the taxable year in computing the taxpayer's net earnings from self-employment subject to tax under section 1401.* (Emphasis added).

Section 704(d) of the Code provides that a partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

Section 707(c) of the Code provides a rule with respect to guaranteed payments made by a partnership to a member of the partnership. It provides that to the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses).

Section 1.707-1(c) of the Income Tax Regulations provides that guaranteed payments do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b) and 708(b). In addition, § 1.707-1(c) states that for purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income. Section 1.1402(a)-1(b) of the Income Tax Regulations provides that guaranteed payments are treated as gross income subject to self-employment tax.

A general partner in a partnership is subject to SECA tax on his or her self-employment income as defined in § 1402(b). The Code defines "self-employment income" as the NESE derived by an individual with certain adjustments. NESE as defined in § 1402(a) takes into account deductions that are allowed by subtitle A with regard to any trade or business carried on by the individual and includes the partner's distributive share of the income or loss from any trade or business carried on by the partnership, subject to the special rules under §1402. If a partner incurs losses from partnership activities, there are rules or code provisions that limit the amount of losses a partner is allowed to take for general income tax purposes on the individual partner's tax return. These provisions include, in the order that applies: first, basis loss limitation under § 704(d); second, at-risk loss limitation under § 465; and third, passive activity loss limitation under § 469. Since the calculation of NESE specifically incorporates the effect of subtitle A income tax provisions in determining deductions from trades or businesses carried on by the taxpayer and the partnership provisions in determining the distributive share of any loss,

any loss limitation rule that applies for determining a partner's general income tax liability should also apply for determining a partner's SECA tax liability, unless a particular Code provision or regulation provides otherwise.²

Specific guidance indicates that the basis loss limitation under § 704(d) and the passive activity loss limitation under § 469 apply to determine a general partner's NESE under § 1402 for SECA tax purposes. Stating, in part, that "[a]n individual's distributive share of such income or loss of a partnership shall be determined as provided in section 704," Treas. Reg. § 1.1402(a)-2(d) pulls in the basis loss limitation under § 704(d) into the computation of NESE.

Also, Treas. Reg. § 1.469-1T(d)(3) provides that a deduction under § 469 or the regulation is not taken into account for *any* subtitle A tax, which includes SECA tax imposed under §§ 1401 through 1403. Furthermore, the example under that regulation specifically articulates that "[passive activity] loss is not taken into account for the taxable year in computing the taxpayer's net earnings from self-employment subject to tax under section 1401" when the loss is not taken into account in computing a taxpayer's taxable income subject to tax under section 1. Although the example does not expressly involve a passive activity loss from a partnership, the regulation provision it illustrates makes no distinction between individuals conducting the trade or business directly and partners in a partnership conducting the trade or business.³

Furthermore, § 465 applies in determining NESE of individuals carrying on a trade or business because § 1402(a) expressly takes into account deductions that are allowed by subtitle A (which is inclusive of the loss limitation rule of § 465) with regard to any trade or business carried on by the individual. While there is no similar guidance under § 1402 or § 465 that expressly states that the at-risk loss limitation under § 465 also applies for purposes of calculating NESE of general partners for SECA tax purposes,

² Some taxpayers have erroneously cited to Revenue Ruling 56-675, 1956-2 C.B. 459, as authority that NESE is not affected by the loss limitations under §§ 704(d), 465, and 469. It is our position that this ruling is not an authority on the application of the various loss limitations for SECA tax purposes. Rev. Rul. 56-675 stated that under § 1.1402(a)-1(a)(2) of the regulations, guaranteed payments are treated as gross income subject to SECA tax. However, where a partner's distributive share includes a loss resulting from the operation of the partnership business, including the deduction for guaranteed payments treated as a business expense under section 162, the self-employment income is the net amount computed by applying to the guaranteed payment received by that partner the distributive share of loss. Rev. Rul. 56-675 did not address the application of loss limitations for SECA tax purposes. Since basis cannot be negative, the facts implied taxpayer had sufficient basis, so the loss limitation of § 704(d) would not apply. Also, loss limitations under §§ 465 and 469 did not exist in 1956. Consequently, Rev. Rul. 56-675 is not applicable to whether and how the loss limitation rules apply in determining NESE under § 1402.

³ TAM 9750001 (August 15, 1997) relied on § 1.469-1T(d)(3) and the example in concluding that the losses allocable to the partnership's activity in which he did not materially participate are taken into account for purposes of the calculation of NESE under § 1402, but only to the extent they are allowable for income tax purposes and are not otherwise of a character to be specifically excluded from the calculation of NESE.

applying this loss limitation rule in determining a general partner's NESE under § 1402 for SECA tax purposes is consistent with considering the basis loss limitation under § 704(d) and the passive activity loss limitation under § 469 in computing NESE for a general partner. Like the application of § 469, § 465 determines the extent to which the partner's distributive share of the losses from the partnership carrying on the trade or business is taken into account in determining the partner's taxable income for the taxable year, and its effect is not limited to chapter 1 of the Code. Section 465 generally applies for purposes of the Code, including chapter 2.

Thus, if the individual share of loss from the partnership is disallowed to a partner under §§ 704(d) or 465 for the taxable year, the loss is also not taken into account in computing the partner's NESE for that taxable year for SECA tax purposes, assuming there is no SECA provision or regulation that provides otherwise (such as with excluded rental income).

CONCLUSION

The basis loss limitation under § 704(d) and the at-risk loss limitation under § 465 apply in determining a general partner's NESE under § 1402 for SECA tax purposes, to the same extent these loss limitation rules apply for income tax purposes, unless a specific exclusion applies under § 1402(a). In the Example, under that general fact pattern, no specific exclusion applies under § 1402(a). Therefore, the individual share of the partnership loss of Member A and Member B must be disallowed for both SECA tax and income tax purposes because Member A had insufficient basis and Member B had an insufficient at-risk amount.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

If you have any questions regarding this memorandum, please contact me or NaLee Park at (202) 317-6798.

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